Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

MICHAEL J. O'MALLEY,

Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION,

Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Illinois

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether, in an action by the FDIC to recover on a loan guarantee, 12 U.S.C. § 1823(3) and the *D'Oench* doctrine bar an innocent defendant from asserting a valid written release executed by a bank and issued to the defendant over four years prior to the FDIC's takeover of the bank.

2. Whether, in an action by the FDIC to recover on a loan guarantee, 12 U.S.C. § 1823(e) and the *D'Oench* doctrine bar an innocent defendant from asserting the defense of legal insufficiency, i.e, that essential elements of a contract—mutual agreement and consideration—were missing, thus rendering the guarantee void.

3. Whether, in an action by the FDIC to recover on a loan guarantee, 12 U.S.C. § 1823(e) and the *D'Oench* doctrine bar an innocent defendant from asserting the defenses of release and cancellation where such defenses arise out of the express language of the guarantee.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner, Michael J. O'Malley ("O'Malley"), seeks a writ of certiorari to review an opinion and order of the Supreme Court of Illinois.

OPINIONS BELOW

The order denying O'Malley's Petition for Rehearing was entered by the Supreme Court of Illinois on December 5, 1994 and is reprinted at Appendix ("App.") 30. The October 27, 1994 opinion of the Supreme Court of Illinois is reported at 163 Ill.2d 130, 643 N.E.2d 825 (1994) and is reprinted at App. 1-29. The opinion of the Appellate Court of Illinois for the First District is reprinted at App. 31-69 and is reported at 249 Ill.App.3d 340, 188 Ill.Dec. 248, 618 N.E.2d 818 (1st Dist. 1993).

JURISDICTION

The Supreme Court of Illinois issued its opinion on October 27, 1994. App. 1-29. The Supreme Court of Illinois denied a timely petition for rehearing on December 5, 1994. App. 30. This petition for a writ of certiorari is being docketed in this Court within 90 days from the denial of the petition for rehearing. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

STATUTES INVOLVED

The case involves the interpretation of the Federal Deposit Insurance Act of 1950, 12 U.S.C. § 1823(e), which provides:

> "No agreement which tends to diminish or defeat the right, title or interest of the Federal Deposit Insurance Corporation in any asset acquired by it under this Section either as security for a loan or by purchase shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, including the obligor contemporaneously with the acquisition of the asset by the bank, (3) shall have been approved by the board of directors of the bank or its loan committee which approval shall be reflected in the minutes of said board or committee, and (4) shall have been continuously from the time of its execution an official record of the bank."

STATEMENT OF THE CASE

This case involves an action by plaintiff, the Federal Deposit Insurance Corporation ("FDIC"), to enforce a guarantee signed by defendant, Michael J. O'Malley. The guarantee was found in the files of the First National Bank of Oak Lawn, Illinois ("the Bank") after the Bank failed and the FDIC took control of the Bank's assets. At trial, O'Malley argued that the guarantee was void from the outset or, in the alternative, had been extinguished by the Bank before the FDIC acquired the Bank's assets. The Circuit Court of Cook County, Illinois found, as a matter of law, that these defenses were barred by 12 U.S.C. § 1823(e) (1988). The Circuit Court therefore ruled in favor of the FDIC, and the Illinois Appellate Court affirmed. (249 Ill.App.3d 340.) O'Malley was granted leave to appeal to the Illinois Supreme Court which affirmed the judgment of the Appellate Court over a dissent by Chief Justice Bilandic who contended that O'Malley's obligation to the Bank had been extinguished prior to the FDIC takeover and that 12 U.S.C. § 1823(e) did not apply.

In 1975 O'Malley and Wayne J. Bekta were business partners in various real estate transactions and developments. O'Malley and Bekta were also directors of the Bank. In 1975, O'Malley and Bekta became interested in developing a piece of real estate in Country Club Hills, Illinois. Dennis Dine, an experienced real estate developer and a long standing customer of the Bank, also participated in the transaction. It was agreed that Dine would borrow money, purchase the property, and take title to the property. When the property was developed or sold, all three parties would profit.

Bekta and O'Malley agreed that if Dine could not get a loan from the Bank for the $225,000 purchase price, they

would supply their personal guarantees as security. Sometime prior to February 28, 1975, Bekta and O'Malley signed a guarantee in Bekta's car while the two were making an inspection of their business properties. O'Malley left the guarantee with Bekta.

On February 28, 1975, Dine secured the loan for $225,000. According to O'Malley, the guarantee was not used in connection with the loan because the property in Country Club Hills was appraised for loan purposes at $420,000, nearly twice the amount of the purchase price. O'Malley testified that he did not know how the guarantee got into the Bank file. At the time of trial, Bekta was deceased. Dine also testified with respect to O'Malley's guarantee and supported O'Malley's testimony. He stated that he was unaware that Bekta or O'Malley had guaranteed the loan. The first time he became aware of any such guarantee was during his deposition.

John Geary was the loan officer who personally handled and approved the $225,000 loan to Dine on February 28, 1975. Geary was also president of the Bank. At trial, Geary testified that the only collateral required for the Dine loan was the Country Club Hills property which had been appraised at $420,000 and would therefore adequately serve as collateral for a loan of $225,000. Geary testified that the Dine loan was not made on the basis of any guarantee signed by Bekta or O'Malley. He further testified that he first saw the guarantee during his discovery deposition before trial.

O'Malley offered bank records into evidence. No reference to a guarantee was found in the loan proposal prepared by Geary in 1975, the collateral checklist, or a collateral audit report. Other bank records also did not refer

to the guarantee.[1] All of the above records were in existence and included among the Bank's official records when the FDIC took over the Bank in 1983. Thus, the FDIC had ample notice from these records that the Dine loans were not subject to any guarantee.

Moreover, Geary testified that in all cases where a guarantee is required with respect to a loan, a copy of a receipt of the guarantee is retained in the collateral register kept by the Bank. However, no collateral receipt existed with respect to the guarantee in this case. Furthermore, FDIC examiner, Greg Adamonis, testified that he found no mention of the guarantee in the thousands of Bank documents he examined.

In April of 1981, the Bank sold the two 1981 Dine notes to the LaSalle National Bank. The sale was approved by Geary. The vice president of the commercial lending department at LaSalle National Bank testified that he was unable to locate any document among LaSalle's records that would indicate that a guarantee formed a part of the collateral or documentation for the Dine loans which were purchased by the LaSalle National Bank. LaSalle National Bank later sold the notes back to the Bank.

In 1979, four years after the loan was made to Dine and four years before the FDIC takeover, O'Malley ended

[1] A memorandum to the credit file dated July 18, 1977 makes no mention of any guarantee despite the fact that Dine's note was apparently overdue at that time. Similarly, another memorandum to the credit file dated February 28, 1975 does not reflect any guarantee for the Dine's loans. Also, a summary report prepared sometime after April 19, 1990 containing information on all outstanding loans of Dine and Dennis Dine Inc. listed no guarantees collateral or as part of the documentation pertaining to the Dine loans.

his relationship with the Bank. He, therefore, sold his stock in the Bank and resigned as a director. He had no further dealings with the Bank after that date.

John Geary corroborated O'Malley's testimony. Geary testified that in 1979, O'Malley sold his stock in the Bank and terminated his business relationships with the Bank. This was part of an arm's length transaction and both sides were represented by counsel. At that time Geary, as president of the Bank, gave O'Malley a written release releasing him from any and all obligations he owed to the Bank, including guarantees. The release was witnessed by the vice president of the Bank, Nancy Adams. In return, Geary demanded and received from O'Malley a written release, releasing the Bank from any obligations it owed to O'Malley. At the time, Geary had the requisite authority to release guarantees to the same extent that he was authorized to approve loans. Geary's lending authority for secured loans was then between $350,000 and $750,000, well in excess of the amount of the guarantee. Geary testified that the releases were placed in the Bank files. Geary did not give the guarantee back to O'Malley, nor did O'Malley request it, because they did not know that it was among the Bank's records.

Greg Adamonis, an FDIC examiner, testified that he did not find any releases in his examination of the Bank's records. However, Adamonis also testified that there were approximately 500 boxes of bank documents in the possession of the FDIC and that he had not personally inspected all of them. Among the files Adamonis did not inspect were O'Malley's files, Bekta's files and the Bank's corporate files.

The FDIC did find two outstanding and unpaid notes signed by Dine. The FDIC sought repayment from Dine

but Dine filed bankruptcy. In September 1983, the FDIC demanded payment from O'Malley under the guarantee. O'Malley refused and the FDIC brought this action. O'Malley filed an Answer asserting the release he received from the Bank in 1979.

In its Reply to O'Malley's Answer, which the FDIC filed in 1984, the FDIC did not attack the validity of the release. Not until October 1987, in a motion for summary judgment, did the FDIC assert for the first time that O'Malley was precluded from asserting the release based upon 12 U.S.C. § 1823(e).

When the FDIC disclosed its reliance on 12 U.S.C. § 1823(e), O'Malley sought leave to have an expert, the accounting firm of Ernst & Whinney, conduct a document audit of the Bank's records to attempt to locate a copy of the release since one of the specific requirements of Section 1823(e) is that the release be an "official record of the Bank." O'Malley also sought the disclosure of the names of the FDIC "closing team" who participated in the closing of the bank. The trial court refused to grant O'Malley's request. Therefore, O'Malley was not in a position to rebut the testimony of the FDIC witnesses who testified they did not find the release in the Bank's records but who admittedly did not look for the release in several critical Bank files including O'Malley's, Bekta's and the Bank's corporate files.

Following a bench trial, the Circuit Court of Cook County, Illinois entered judgment in favor of the FDIC and against O'Malley finding that the guarantee executed by O'Malley guaranteed the Dine loans and that the FDIC was entitled to recover thereunder. The Circuit Court also ruled that 12 U.S.C. § 1823(e) barred O'Malley from asserting the release as a defense to the FDIC's claim on the guarantee. (See App. 73-75.)

O'Malley filed a post trial motion seeking a new trial which the trial court denied. O'Malley appealed to the Illinois Appellate Court which affirmed the trial court's decision. Presiding Illinois Appellate Court Justice Gordon dissented. O'Malley was granted leave to appeal to the Illinois Supreme Court which affirmed the judgment of the Appellate Court. Chief Justice Bilandic dissented as did Justice Harrison.

In his dissenting opinion, Chief Justice Bilandic characterized the majority's opinion as being "factually flawed by its erroneous application of Section 1823(e) to the facts of this case. O'Malley's guarantee was discharged by mutual releases exchanged between O'Malley and the Bank. The FDIC has no authority to enforce a non-existent guarantee."

REASONS FOR GRANTING THE WRIT

Summary of Argument

12 U.S.C. § 1823(e) was enacted to protect the FDIC from secret side agreements between an insolvent bank and a bank obligor, entered into at the time of the obligation and which, if given effect, would render the obligation illusory and unenforceable. *Langley v. FDIC*, 484 U.S. 86 (1987); *Armstrong v. Resolution Trust Corporation*, 157 Ill.2d 49 (1993). Section 1823(e) is primarily concerned with situations where a bank and the obligor have engaged in a "deceptive scheme or arrangement whereby the banking authority is likely to be misled." *FDIC v. Meo*, 505 F.2d 790 (9th Cir. 1974); *FDIC v. Maris*, 121 Ill.App.3d 894, 460 N.E.2d 367 (1st Dist. 1984).

Section 1823(e) was never intended to prevent an innocent party from asserting the obligation's legal insufficiency (distinct from any side agreement) or a subsequent valid release or cancellation, particularly where the release or

cancellation is contemplated by the express language of the obligation, itself.

The last time the United States Supreme Court considered 12 U.S.C. § 1823(e) was in 1987 when it decided the *Langley* case. Since that time, there have been a large number of bank failures in this country. This, in turn, has produced a multitude of FDIC collection and foreclosure actions involving the application of 12 U.S.C. § 1823(e) to the various defenses raised in those cases.

Many of the cases interpreting 12 U.S.C. § 1823(e) are simply irreconcilable. One line of cases have permitted defendants to assert releases to show that the FDIC did not "acquire an asset" because it had been extinguished prior to the FDIC takeover. This is the so-called "no asset" exception to 12 U.S.C. § 1823(e). (See *FDIC v. McFarland*, 33 F.3d 532 (5th Cir. 1994); *Commerce Federal Savings Bank v. FDIC*, 872 F.2d 1240 (6th Cir. 1989); *FDIC v. Nemecek*, 641 F.Supp. 740 (D. Kan. 1986).)[2] Other cases have allowed defenses to be asserted which arise out of language contained in the very instrument that the FDIC seeks to enforce. (See, *Howell v. Continental Credit Corp.*, 655 F.2d 742 (7th Cir. 1981.) *Langley*, itself, suggested that "real defenses" that show that the instrument

[2] In *Commerce* and *Nemecek* the releases were not in the banks' files. In *McFarland*, the release was part of the bank's records but not signed by the guarantor or reflected in the loan committee's minutes. Also in *McFarland*, other than the guarantee, there was no evidence in the bank's records that the subject loan was secured by a guarantee. That is the same situation in this case. Moreover, here, the FDIC did not make a thorough search of the Bank's records to see if it could locate the release and O'Malley was prohibited from doing so by the trial court. Thus, it is unfair to assume that the release was not in O'Malley's file at the Bank which the FDIC never checked.

was entirely void from the outset may be asserted, notwithstanding 12 U.S.C. § 1823(e).

In the instant case, the Illinois Supreme Court expressly acknowledged the conflict among the federal courts regarding the application of 12 U.S.C. § 1823(e):

> O'Malley also relies on *Federal Deposit Insurance Corp. v. Nemecek*, 641 F.Supp. 740 (D. Kan. 1986), to support his "no-asset" argument. In *Nemecek*, the court allowed the defendants to introduce an oral accord and satisfaction against the FDIC. In that case, the court held that an oral accord and satisfaction extinguished a note before the FDIC took control of a bank, so Section 1823(e) did not apply. O'Malley argues that the same reasoning should apply to his release agreement.
>
> We note that the reasoning in *Nemecek* has been criticized by other courts. (*Federal Deposit Insurance Corp. v. National Consumer Alliance, Inc.*, 1994 WL 326064 D. an. 1994), (noting that *Nemecek* was decided before the Supreme Court's narrow construction of Section 1823(e) in *Langley*); *Cimarron Federal Savings & Loan Association v. McKnight*, 840 P.2d 648 (Okla. App. 1992); *Cover*, 714 F.Supp. 455.) In *Cover*, the court stated that to adopt the logic of *Nemecek* "would destroy the effect and protection of § 1823(e) and hamper the FDIC's ability to follow the purchase and assumption alternative by injecting uncertainty into the valuation of assets." (*Cover*, 714 F.Supp. 458.) In addition, the *Nemecek* reasoning is inconsistent with the reasoning of other courts that have addressed O'Malley's "no-asset" argument. We therefore decline to follow *Nemecek*.

However, other cases have followed *Nemecek* including the case of *Commerce Federal Savings Bank v. FDIC*, 872 F.2d 1240 (6th Cir. 1989) which Chief Justice Bilandic regarded as controlling in this case. (Also see, *Grubb v. FDIC*, 868 F.2d 1151 (10th Cir. 1989).)

Thus, this case presents an issue of great public importance at a time of frequent bank failures, viz., whether a defendant may assert a valid release obtained from a bank in a subsequent action by the FDIC to recover a loan or is he barred from doing so under 12 U.S.C. § 1823(e). If *FDIC v. Nemecek*, 641 F.Supp. 740 (D. Kan. 1986) and the cases which recognize the "no asset" exception to 12 U.S.C. § 1823(e) are correct on this issue, then the instant case presents a perfect opportunity for this Court to say so, settle the issue, once and for all, and resolve the apparent confusion and conflict which currently exists concerning the applicability and scope of the "no asset" exception.

1. O'Malley's defense of release where such release was in writing, signed by the Bank, and executed four years prior to the FDIC's takeover was not barred by 12 U.S.C. § 1823(e).

Four years before the FDIC took over the Bank, O'Malley received a written release from the Bank, signed by its president, which released O'Malley from "any and all obligations owed to the bank," as of October 1, 1979. In consideration for this release, O'Malley also released the Bank from all liability. Thereafter, O'Malley had no further dealings with the Bank.

Everyone—the FDIC, the trial court, the Illinois Appellate Court, and the Illinois Supreme Court—conceded that the Bank's release to O'Malley was valid under common law principles. Thus, O'Malley's guarantee was no longer an asset of the Bank at the time of the FDIC takeover in 1983, having been extinguished as a bank asset—along with any and all other obligations O'Malley owed the Bank—at the time the release was given to O'Malley in 1979.

Thus, 12 U.S.C. § 1823(e) has no application to this case since such statute, by its very terms, only applies "to any asset acquired by" the FDIC by reason of an FDIC takeover. Previously extinguished assets are not covered by 12 U.S.C. § 1823(e). *FDIC v. Nemecek*, 641 F.Supp. 740 (D.Kan.1986), *Commerce Fed. Sav. Bank v. FDIC*, 872 F.2d 1240 (6th Cir. 1989),[3] and *FDIC v. Prann*, 694 F. Supp. 1027 (D.P.R. 1988).

This point was clearly spelled out in the *Nemecek* case where the court held that:

> this Court is convinced that Section 1823(e) has no application to this case. The Bank and the Defendants had reached an accord and satisfaction, a settlement of claims, prior to the Bank's closing. Therefore, when the FDIC purchased the Bank's assets it could not have purchased Defendant's note as it had previously been extinguished. Section 1823(e) applies only

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[3] In *Commerce*, an individual and a corporation owned real estate. The two borrowed $125,000 from a bank. As security for the loan, the borrowers executed a deed of trust which contained a clause covering future borrowings. The deed of trust also had a provision that the trust would be extinguished if all outstanding debts encumbering the instrument were paid.

The balance of the $125,000 was paid, and the bank orally agreed to release the deed of trust. Meanwhile the bank failed. The FDIC was appointed receiver. The FDIC acquired various assets of the failed bank, including the deed of trust and a second promissory note for $50,000 executed by the corporation. The FDIC refused to release the deed of trust, contending that the $50,000 obligation was secured by the deed of trust. The FDIC argued that the oral agreement to release the deed was barred by § 1823(e).

The Sixth Circuit rejected the FDIC's position in *Commerce* and held that the deed of trust was not an asset acquired by the FDIC. The court concluded that the original $125,000 indebtedness had been satisfied before the FDIC's purchase and that the oral agreement to release the trust deed was enforceable and not barred by § 1823(e).

to assets which the FDIC has acquired." *FDIC v. Nemecek*, *supra*, at 743.

The instant case presents an even more compelling case than *Nemecek* or *Commerce*. Here there was a *written* release. In *Nemecek* and *Commerce*, the accord and satisfaction and release were *oral* yet the courts in those cases allowed the releases to be asserted against the FDIC, notwithstanding 12 U.S.C. § 1823(e).

The unrebutted testimony in this case is that the release obtained by O'Malley from the Bank was in writing, signed by the Bank president and supported by valuable consideration (i.e. O'Malley's release of the Bank). These facts are sufficient to defeat any possible claim that the release was illusory in nature, thereby distinguishing this case from those involving a "hidden side agreement" which is the real concern of Section 1823(e). See *Armstrong v. Resolution Trust Corporation*, *supra*.

2. O'Malley's defense of legal insufficiency was not based on any side agreement but on the fact that two of the essential elements of a contract—mutual agreement and consideration—were missing from the guarantee, rendering the guarantee entirely void from the outset and, therefore, outside the scope of 12 U.S.C. § 1823(e).

The uncontroverted evidence in this case is that there was never any agreement among the Bank, Dine, and O'Malley to have O'Malley give a guarantee for Dine's loan; the O'Malley guarantee played no part, whatsoever, in the Dine loan transaction and, most certainly, did not serve as any part of the consideration for such loan; no consideration was given by the Bank for the O'Malley guarantee; and the Bank records which would customarily reflect a guarantee did not reflect any guarantee for the Dine loans and this was known by the FDIC.

In the face of this overwhelming evidence that O'Malley never guaranteed the Dine loans, the FDIC offered no rebuttal evidence whatsoever. Instead, the FDIC argued that, under 12 U.S.C. § 1823(e), O'Malley was prohibited from arguing that the guarantee was legally insufficient from the outset.

However, the FDIC's reliance on 12 U.S.C. § 1823(e) is misplaced. Nothing in Section 1823(e) prohibits O'Malley from litigating whether one or more of the essential elements of a contract are missing with respect to the guarantee. This is evident from the language of 1823(e) itself which provides, in pertinent part, as follows:

> *No agreement* which tends to diminish or defeat the right title, or interest of the [FDIC] in any asset acquired by it under this Section. . . . shall be valid against the Corporation unless such agreement . . . (Emphasis added.)

The clear language of Section 1823(e), as well as the case law interpreting such section, makes clear that it was designed merely to protect the FDIC from unrecorded "side agreements" but was never intended to foreclose a party from contesting the contractual validity of the underlying obligation. See, *Commerce Federal Savings Bank v. FDIC*, 872 F.2d 1240 (6th Cir. 1989).

In *Commerce*, the Court stated at 1245:

> "The purpose [of Section 1823(e)] is to protect the FDIC from hidden agreements which could defeat its interest in what is otherwise a facially valid note. Such hidden agreements would prevent the FDIC from accurately valuing assets and from making informed decisions on how best to handle the Bank's insolvency. The concern is thus with agreements that are not made part of the note. [citations omitted]

> In contrast, however, the statute "does not apply when . . . the parties contend that no asset exists . . . and that such invalidity is caused by acts independent of any understanding or side agreement." *Merchants Nat'l Bank of Mobile* 725 F.2d at 639 (emphasis in original); *Blue Rock Shopping Center, Inc.*, 766 F.2d 1262, 1267 (6th Cir. 1985) ("By its terms, [Section 1823(e)] protects the FDIC from unwritten agreements that otherwise might be asserted to diminish or defeat its rights in assets acquired from a failed bank. However, the claim asserted by [appellant] is not in the nature of an agreement."); compare *Federal Deposit Ins. Corp. v. Prann*, 694 F.Supp. 1027, 1037 (D. P.R. 1988) (Section 1823(e) is inapplicable to the present case because the debt which forms the basis of the asset claimed by FDIC was satisfied before FDIC acquired the bank's assets.") (emphasis in original)' *Federal Deposit Ins. Corp. v. Nemecek*, 641 F.Supp. 740, 743 (D. Kan. 1986) ("[W]hen the FDIC purchased the Bank's assets, it could not have purchased defendants' note, as it had been previously extinguished. Section 1823(e) applies only to assets which the FDIC has acquired.") (emphasis in original)' cf. *Federal Deposit Ins. Corp. v. Venture Contractors, Inc.*, 825 F.2d 143, 149 (7th Cir. 1987) (FDIC bound by limitations contained in the interest acquired under purchase and assumption agreement); *O'Neil*, 809 F.2d at 354 (Section 1823(e) is not implicated by a defense which "appeared in the asset itself."). (872 F.2d at 1245.)

See also *Armstrong v. Resolution Trust Corporation*, 157 Ill.2d 49 (1993) in which the Illinois Supreme Court also observed that the primary objective of Section 1823(e) was to protect against secret verbal side agreements.

O'Malley's attack on the guarantee is not based on a secret side agreement but on the legal insufficiency of the guarantee itself. This is a "real defense" which this Court

appeared to exempt from the scope of 12 U.S.C. § 1823(e) in *Langley v. FDIC*, 484 U.S. 86 (1988).

In this case at least two of the essential elements of a valid contract are missing with respect to the guarantee—there was no mutual agreement among the parties concerning the guarantee and there was no consideration given for the guarantee. Relative to these points, the evidence was irrefutable that the Bank made the loan to Dine without regard to and without any knowledge of the so-called O'Malley guarantee. Obviously, then, the loan to Dine was not made in consideration of O'Malley's guarantee. Thus, such purported guarantee must fall for want of mutual agreement and lack of consideration.

These defenses are "real defenses" that go to the very essence of the guarantee's contractual validity and in no way rely on any "side agreement" between O'Malley and the Bank to defeat the guarantee. Thus, they are not barred by Section 1823(e). (See, *FDIC v. Meo*, 505 F.2d 790 (9th Cir. 1974) where the Ninth Circuit held that *D'Oench Duhne & Co. v. FDIC*, 315 U.S. 447 (1942)—which 12 U.S.C. § 1823(e) codified—did not preclude a defendant from asserting the affirmative defense of lack of consideration in an FDIC action to collect a promissory note; See also, *FDIC v. Venture Contractors, Inc.*, 825 F.2d 142 (7th Cir. 1987.)

3. O'Malley's defenses of release and cancellation arose out of the language of the guarantee and were, therefore, not barred by 12 U.S.C. § 1823(e).

Section 1823(e) does not apply where the defense raised appears in writing on the face of the instrument that the FDIC seeks to enforce. This rule was announced in the case of *Howell v. Continental Credit Corp.*, 655 F.2d 743

(7th Cir. 1981) where the Seventh Circuit permitted the defendant to raise certain contractual defenses which arose out of the very instrument that the FDIC was seeking to enforce. The Court in *Howell* stated as follows:

> The defense appellant posits here arises directly and explicitly from the provisions of the leases which were in the bank's files and which the FDIC now seeks to enforce. We have not been presented with any persuasive reason why appellant's defense should not at least be tested at trial.
>
> The details of exactly how Continental [the original lessor] was to acquire title and the remaining factual details of appellant's defense are flagged on the face of the instrument and are issues for trial . . . [t]he fact that the Court must go outside of the leases to test the strength and validity of the defenses is not fatal *where the foundation and basis of that defense is in a document arguably meeting the non-secrecy requirements of Section 1823(e).* (*Howell v. Continental Credit Corp.*, 655 F.2d at 748, emphasis supplied.)

Similar reasoning was also utilized in *Riverside Park Realty Co. v. FDIC*, 465 F.Supp. 305 (M.D. Tenn. 1978), where the Court in that case held that Section 1823(e) did not bar the raising of a separate agreement as a defense to the foreclosure of a deed in trust by the FDIC. The Court held in *Riverside* that since the terms of the deed in trust made reference to the loan agreement which the defendants claimed had been breached, Section 1823(e) did not apply.

The rule in the *Howell* case was also followed in *FDIC v. Panelfab Puerto Rico, Inc.*, 739 F.2d 26 (1st Cir. 1984), a case involving facts very similar to those in the present case. In *Panelfab*, the FDIC filed suit against the defendants on a written guarantee of a $200,000 note. As in this case, the defendants in *Panelfab* claimed that the

guarantees had been canceled several years prior to the FDIC's takeover. The FDIC asserted that the cancellation of the guarantees was ineffective because the defendants had not complied with the provisions of Section 1823(e).

In *Panelfab*, there was nothing in the bank records to reflect that the cancellation of the guarantee agreements had been approved by the directors of the bank or its loan committee. Holding that the provisions of Section 1823(e) did not apply to invalidate the defendants' claims that the guarantee had been canceled, the Court of Appeals commented:

> The FDIC asserts that the cancellation of the letter of guarantee constitutes . . . the invocation of an agreement which tends to diminish or defeat the FDIC's right in this case. . . . Because the cancellation itself cannot be an agreement, the agreement to which the FDIC refers can only be the letter of guarantee which includes the clause outlining the means of a unilateral cancellation.
>
> Specifically, we will not consider the guarantee agreement as a whole to be valid for the purpose of collecting on the debt only to invalidate under 1823(e)(3) a particular option contained in the agreement that, when exercised according to its terms, is a defense to that collection. (*FDIC v. Panelfab Puerto Rico Inc.*, 739 F.2d at 30.

In the present case, the purported guarantee contains the following language:

> The bank may from time to time, without notice to the undersigned (or any of them), . . . (d) *release* or compromise any liability of any of the undersigned hereunder, or any liability of any other party or parties primarily or secondarily liable on any of the liabilities, . . . (Emphasis added.)

Thus, the "foundation and basis" of O'Malley's defense of release is derived from the very document which the FDIC seeks to enforce, i.e., the guarantee, and such defense is, therefore, not barred by Section 1823(e) under the *Howell* doctrine.

The guarantee document in this case also contained the following language:

> . . . any of the undersigned and any person duly authorized and acting on behalf of any of the undersigned, may give written notice to the bank of discontinuance of this guarantee as to the undersigned by whom or on whose behalf such notice is given . . . .

Therefore, the defense of "cancellation," which was raised by O'Malley, also has its "foundation and basis" in the guarantee document itself. Here, the exchange of releases between O'Malley and the Bank clearly constituted "written notice to the bank of discontinuance," as well as notice to the Bank that O'Malley was no longer a party to any guarantee. Since the document upon which the FDIC based its entire case, i.e., the guarantee, contained a provision by which O'Malley could—and *did*—cancel his guarantee, the FDIC should not have been permitted to invoke Section 1823(e) to bar either O'Malley's release or cancellation defense.

4. A literal interpretation of Section 1823(e) makes compliance with such statute impossible insofar as releases are concerned.

Under a literal interpretation of Section 1823(e), any release not executed "contemporaneously" with the execution and delivery of the guarantee is invalid under § 1823(e)(2). This interpretation is, of course, absurd since contemporaneous execution of a guarantee and a release

never occurs in the real world. The FDIC virtually conceded this point in the brief it submitted to the Illinois Supreme Court but it shrugged this off by saying that "harsh results" sometimes happen.

Unfortunately, under a literal interpretation of § 1823(e)(2), the FDIC can use the statute to invalidate any release it chooses (since few if any releases are executed contemporaneously with the obligation), including the release of a home mortgagor, a guarantor, or any other obligor of a bank, regardless of the legitimacy of the transaction. Surely this type of broad and arbitrary power was never intended by Congress, nor should it be permitted by this Court.

Also, under the FDIC's strict and literal interpretation of subsection (2) of § 1823(e), any release not signed by the "person or persons claiming an adverse interest thereunder, including the obligor. . ." would also be invalid. Since the person being released does not customarily sign the release document, this again results in an absurd situation where the FDIC can use § 1823(e)(2) to invalidate virtually any release it chooses. (The Court, in *McFarland, supra,* rejected this interpretation in a case where the defendant had not signed the release.)

CONCLUSION

Section 1823(e) protects the FDIC from secret side agreements between a defendant and a bank. Here, there was no secret side agreement with the Bank. The understanding that the guarantee would not be delivered to the Bank unless needed for the Dine loan, was strictly among O'Malley, Bekta, and Dine, in their individual capacities. The Bank knew nothing about this understanding—and certainly was not a party to it. It is uncontroverted that

the Bank made the loan to Dine without even knowing about the guarantee. It is also uncontroverted that the Bank released O'Malley from any and all claims, four years prior to the FDIC takeover. It is apparent from these uncontroverted facts that O'Malley does not seek to assert any secret side agreement he had with the Bank—there was none. Thus, Section 1823(e) is inapplicable and does not bar his defenses of release and legal insufficiency.

The opinion of the Supreme Court of Illinois in this case interpreting Section 1823(e) conflicts with the *Nemecek*, *Commerce*, *Howell*, and *McFarland* decisions. In view of the rising number of bank failures in this country and the resulting litigation by the FDIC, it is certain that lower courts will continue to be called upon to interpret Section 1823(e) in the future. Petitioner respectfully submits that certiorari should be granted in this case to resolve the conflict among the federal and state courts regarding the scope of Section 1823(e).

For all the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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